Report to the Secretary of the Treasury
from the Treasury Borrowing Advisory Committee
of the Securities Industry and Financial Markets Association

May 4, 2010

Dear Mr. Secretary:

Since the Committee met in early February, incoming data confirm that the economic expansion is moving onto a self-sustaining path. Although aggressive policy stimulus and a turn in the inventory cycle provided the initial spark for recovery, the sources of growth have broadened into private final demand. This shift appears to be generating gains in labor income and an improvement in financial conditions. Ongoing drags from tight credit markets and strained public finances are likely to temper the strength of the recovery for some time and slow the decline in the unemployment rate. However, the prospects for sustaining growth are good.

On the heels of a 5.6% annualized gain in the final quarter of 2009, GDP growth moderated to 3.2% last quarter. Although a large inventory contribution faded some, growth continues to be supported from a turn in the stock-building cycle. Importantly, the recovery in final sales is finding firmer ground as equipment spending, exports and personal consumption each posted a third consecutive gain last quarter. The manufacturing sector continues to benefit from the lift in domestic and foreign demand, with output rising at a 6.6% pace last quarter. The most recent readings from business surveys – including a 60.4 ISM manufacturing survey in April – point to further rapid gains this quarter. Indicators such as the ISM non-manufacturing survey and the establishment survey of private service employment have moved higher, suggesting that growth in the service sector is now gaining momentum.

Retail sales expanded briskly in the first quarter, supporting growth in real consumption at a 3.6% annual rate. It appears that households are responding to resumption in labor income growth – compensation rose at a 3.6% annualized pace last quarter – alongside rising equity wealth, and a gradual opening up of credit availability. As a result, a sharp upward adjustment in the saving rate appears to have ended. However, last quarter's fall in the saving rate is not likely to be repeated and most forecasts anticipate rising saving this year that holds spending gains close to its recent pace, even as labor income growth is sustained.

A shift in business behavior is likely to provide much of the support for economic growth this year. Aggressive cost control enabled firms to limit the decline in profits during the recession and the resumption in growth has produced strong earning gains. Although profits are growing rapidly, levels of inventories, capital equipment spending and hiring remain depressed. Coming off these lows, business spending has experienced solid growth, and survey indications point to a continuation of this trend.

Although business and household spending are expanding, ongoing drags are restraining the pace of overall economic growth. Depressed housing markets and concerns about job security still weigh on household sentiment. Federal fiscal stimulus is fading and there remains intense pressure on state and local finances. Indeed, state and local spending has contracted at a 3% pace over the past two quarters. More generally, uncertainty about the tax and regulatory environment could weigh on business spending.

No meaningful fiscal consolidation is expected this year and the 2010FY Federal budget deficit is likely to be approximately $1.4 trillion (9.4% of GDP).

In spite of a return to growth, depressed levels of resource utilization are pushing core inflation lower. Over the past six months the core CPI rose at a 0.6% annualized rate, the lowest six month increase since the early 1960s. With trends in labor costs and service prices still moving lower, it looks likely that core consumer prices will rise less than 1% this year, the first time on record. Although the Federal Reserve has faced the challenge of high unemployment and low inflation in the past, this is first episode in which it has faced these conditions at the same time. With the unemployment rate likely to end the year above 9%, a fall in core inflation below 1% will likely leave the Federal Reserve on hold through the end of this year.

The Federal Reserve's exit from providing exceptional liquidity support is substantially complete. However, the program of large scale asset purchases has left the Federal Reserve balance sheet large by historic standards. Programs to neutralize the effect of the large balance sheet on interbank lending rates are being tested. The debate concerning the timing and sequencing of outright asset sales from the SOMA portfolio is ongoing. Even after this debate is concluded, any action on asset sales will most likely wait at least until levels of employment and inflation are consistent with a tightening in policy.

Against this economic backdrop, the Committee's first charge was to examine what adjustments to debt issuance, if any, Treasury should make in consideration of its financing needs. The Committee continues to feel that the current issuance schedule is appropriate. Given the better than expected near-term and medium-term fiscal outlook, a reduction in nominal coupon issuance is necessary. Consistent with the desire to increase the average maturity of outstanding debt, the Committee recommends that issuance sizes in two-year, three-year, and five-year maturities be reduced meaningfully, with smaller reductions in seven-year, ten-year, and thirty-year maturities. However, given Treasury's commitment to increase TIPS issuance over time, the Committee recommends growing the size of ten-year TIPS.

The second charge was to, in light of the recent focus on sovereign credit risk, comment on the use of sovereign credit default swaps (CDS). The member gave an overview of the sovereign CDS market, highlighting its size, drivers, major participants, benefits, and risks. Given the small size of sovereign CDS open interest relative to debt outstanding, the member concluded that CDS was unlikely to be a major driver of funding costs for sovereigns. The most active sovereign CDS contracts reference Western European nations. This reflects investors' concerns over current debt woes, coupled with an inability for the referenced sovereigns to print their own currency. By contrast, net notional outstanding in US sovereign CDS amount to less than .03% of US debt held by the public. In summary, the member recommended that banning "naked shorts" should not be adopted and that regulators should focus on solutions that prevent contagion without reducing market liquidity. One proposed area of reform would be to limit net notional outstanding as a function of underlying debt outstanding (presentation attached).

The third charge was to examine the causes and implications of the recent narrowing in interest rate swap spreads relative to US Treasuries. The member attributed the narrowing since the 2008 crisis to the government's wrapping of bank liabilities, increased supply of government debt, swapped corporate issuance, and the absence of mortgage hedging due to the Federal Reserve's asset purchase program. Also of note, was the graph that illustrated the high correlation between the budget deficit as a percentage of nominal GDP and 10-year swap spreads. The member concluded that one with a longer investment horizon could take advantage of negative swap spreads by opportunistically paying fixed (presentation attached).

In the final charge, the Committee considered the composition of marketable financing for the remainder of the April-June quarter and the July-September quarter. The Committee's recommendations are attached.

Respectfully,

Matthew E. Zames
Chairman

Ashok Varadhan
Vice Chairman